Transitioning to Offshore Sourcing Challenges

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Abstract
Transitioning to offshore sourcing has become a seductive argument for cost reduction. Most managers agree that the impact has been beneficial to the consumer and the trading conglomerates. This paper addresses public perceptions, structural issues, geopolitical and demographic factors that fuel the offshore sourcing argument. It addresses design, marketing, sourcing, and logistics, local and cultural idiosyncrasies of offshore sourcing that assures a successful venture.

Introduction
Offshore sourcing is a hot topic, often having economic and emotional underpinnings. Critics of offshore sourcing have blasted captains of industry as being greedy and selling out America. Corporate supply chain managers extol the virtues of offshore outsourcing as an inevitable result of globalization of the world economy. These pundits point out to cost containment and increased availability of cheap goods and services. The environmentalists, not to be outdone in this debate point out to the looting of natural resources and pollution of air and land in host nations that have been the beneficiary of the offshore outsourcing phenomenon.

The truth is a convergence of all the above utterances: Outsourcing is a genie that cannot be put back into the magic bottle.

Historical Perspective
The primary drivers of offshore sourcing are availability of cheap and educated workforce coupled with a receptive government of the host nation that has a stable economic and political structure.

Multinational corporations like IBM, Coca Cola, Unilever and Exxon that developed operations on a global scale typically set the groundwork for understanding the business culture , legal systems and labor relations in the host nations where they set up operations.

These pioneers of international trade quickly copied all successful business practices that worked in their home base and developed a trading/ operations arm in the host nation. The production of most goods was consigned to nations that had high per capita income. Some goods were consumed by the host nations with some tariffs imposed on such consumption. For example petroleum refined by Exxon and soaps and detergents produced were consumed in the host countries. However computers assembled by IBM were predominantly for export, although there was some local consumption

The host nations welcomed the formation of economic and human capital, importation of technology, know-how and management of technology to improve the general standard of living of the populace.

The offshore outsourcing occurred in several waves: first it was European nations like Ireland and Scotland, followed by a second wave across Latin American nations and then across Korea, Philippines, Malaysia and Taiwan. The latest beneficiary of offshore sourcing has been China and India.

The Challenges: Make Vs Buy Option
The Holy Grail of Offshore sourcing is the analysis of the costs under “make in house” versus “buy using offshore sourcing”. As simple as this sounds, often times the costs of in house manufacturing needs careful scrutiny and analysis. Cost accountants can rattle off several types of costs: standard cost, fully burdened cost, marginal cost, variable cost, frozen cost, partially burdened cost etc. etc. All these costs are genuine, however their usage is dependent on the action taken as the result of the analysis.

Most cost accountants will tell you that when in house plant capacity is at 95 % utilization or better, the cost to be used in a make vs offshore sourcing will be “ fully burdened cost” Vs “offshore cost”. However when in house plant capacity is far below 95% utilization, then the appropriate in house cost will be the variable cost with a variable (not full) burden. This reckoning is deceptive simple: however there is one drawback : most companies have seasonal or cyclical fluctuation in market demand that translates to long term/ medium term fluctuations in capacity utilization. So a decision to offshore source when plant capacity utilization is at 95% needs to be revisited when plant capacity drops to say 80 %.

However offshore sourcing decisions tend to be strategic decisions that are rarely revisited when in-house capacity utilization decreases. Also the fixed costs of decommissioning offshore plant and labor structures tend to have political ramifications that the luxury of revisiting the decision is practically non-existent.

The Challenges: The Cost – Productivity – Quality Connection

The single dimensional approach to offshore sourcing has always been the cost advantage. However more and more companies are realizing that cheap labor tends to subvert equipment specialization. A product made in the home nation with high level of equipment specialization and worker skills is more costly that the same product made with cheap labor and less sophisticated equipment. However the life cycle costs of the products may be comparable or even lower in the home nation.

Life cycle costs include transportation costs; cost to service, cost to repair and maintain, cost to incorporate design changes, controlling inventories to meet an uncertain demand.

Identical products made by differing technologies and labor inputs trend to have differing performance characteristics over their useful life.

The cost of manufacturing offshore should include the cost of overseeing quality, the local skills is usually complemented by third part inspection and sometimes inspection prior to shipment. Language barriers and lack of uniform format of technical instructions at times will delay product placement even for fairly stable products.

The Challenges: Selection Criteria for Offshore Host Nation

As mentioned earlier, some nations have had a long term gestation period of assimilation the offshore sourcing phenomenon. These nations have the right combination of technical infrastructure and labor pools. They have had a demonstrated history of success, like Korea, Malaysia and Taiwan in electrical and electronic products, China in consumer products, India in software development.

The Global Competitiveness Report published by The Center for International Development, Harvard University defines two metrics to rank countries / regions on the basis of competitiveness. The first, "Global Competitive Index" (GCI) developed by Professor Jeffrey D Sachs of the Center of International Development at Harvard University developed GCI as " the best prospects for growth over the next five years". This index is based on theoretical and empirical macroeconomics and assesses growth prospects in seventy five nations. The second metric " Current Competitiveness Index" (CCI) was developed by Professor Michael E Porter of the Institute for Strategy and Competitiveness, at the Harvard Business School. This index assesses the current productive potential of seventy five countries. The higher the metric, the better the GCI and CCI. Countries with high level of core innovation (measured by number of patents granted and pressed into commercial use have higher GCI and CCI. The Global Competitiveness Report (2001 – 2002) lists Finland as the highest ranked country with GCI of 6.03, followed by United States at 5.95 and Canada at 5.87. China ranks 39 with GCI of 4.4 and India ranks 57 with a GCI score of 3.84. The Global Competitiveness Report (2001-2002) lists Finland again as the highest ranked country for CCI followed by the United States and Netherlands. China came in at 47th rank and India came in at 36th rank. Note all rankings are based on a selection of seventy countries.

The Challenges: Hot Spots for Offshore Sourcing

According to a survey compiled by Managing Automation, some of the hot spots for design, production and key markets that manufacturers are targeting are mainland China, Canada , Mexico among other regions. The attractiveness of these regions is predicated on supply of materials, large populations with disposable incomes, comparatively low labor (but skilled) rates , local technical universities and English speaking population. Political stability, stable financial institutions and a healthy respect for the law are also conducive factors. Countries high on the list of desired locations to set up operations include Ireland with its educated English speaking population with manufacturing hourly wages of $ 15.54 per hour, Mexico with good infrastructure and low wages of $ 2.61 per hour, Hungary with low trade barriers in the European Union with technically skilled populace with hourly wages of $ 3.77 per hour, Taiwan with established semiconductor business with a technically skilled work force earning $ 5.81 per hour, followed by India with English proficiency and a good infrastructure and availability of technically skilled workers with average wages of $ 2.1 per hour. Countries that are playing catch up include China with the largest market for consumer goods with a good manufacturing infrastructure and low hourly wages of $ 2 per hour followed by Singapore, Thailand, Philippines, Russia, Poland and Turkey. Countries that have yet to make the grade as a desirable globalization turf include South Africa (Rand, their currency is very strong), Chile (small work force) and Argentina (government has a large debt load).

Conclusions

Offshore sourcing is here to stay. It is a complex business process that needs savvy professionals who have a broad understanding of geo-politics, finance and negotiating skills. The internet explosion along with the digital market place has added a technology dimension to the offshore sourcing phenomenon. The transaction costs for material and services procurement has decreased due to the internet auctions of commodity and services.

Countries that had cheap labor now also have technical expertise and know-how to fashion their own destinies as we move into the new millennium.

Offshore sourcing has gained enormous momentum as the result of the internet expansion into supply chain planning and execution. The transaction speeds have increased by several fold. The dependency on technology has also increased several folds. New competencies are required to be successful in offshore sourcing.

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